INDEX

CITATIONS

Cases: Page

Cases-Continued Page

STATUTE:

MISCELLANEOUS

Miscellaneous-Continued

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1973

NOS. 72-1490,-1491

FEDERAL POWER COMMISSION, PETITIONER

v.

TEXACO INC., ET AL.

DUDLEY T. DOUGHERTY, ET AL., CO-EXECUTORS OF THE ESTATE OF MRS. JAMES R. DOUGHERTY, ET AL., PETITIONERS

v.

TEXACO INC., ET AL.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

BRIEF OF DUDLEY T. DOUGHERTY, ET AL.

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A, pp. 1a-22a)1/ is reported at

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1/"Pet. App." refers to the Appendix to the petition for a writ of certiorari of the Federal Power Commission in No. 72-1490. "App." refers to the separately-bound joint appendix in this Court.

474 F.2d 416. The initial order (No. 428) of the Federal Power Commission (Pet. App. D, pp. 29a-46a), its order (No. 428-A) of amendment (Pet. App. E, pp. 47a-49a), and its order (No. 428-B) denying rehearing (Pet. App. F, pp. 50a-84a) are reported at 45 FPC 454, 45 FPC 548, and 46 FPC 47 respectively.

JURISDICTION

The judgment of the court of appeals was entered on December 12, 1972 (Pet. App. B, pp. 23a-25a) and timely petitions for rehearing were denied on February 5, 1973 (Pet. App. C, pp. 26a-28a). The petitions for writs of certiorari were filed on May 3, 1973, and were granted on October 9, 1973. The jurisdiction of this Court rests on 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

Whether the Federal Power Commission has authority to exempt small producers from certain filing requirements under the Natural Gas Act, 15 U.S.C. 717, et seq., and to regulate the interstate wholesale sales of such small producers indirectly through review of the costs to large producers and interstate pipelines of purchasing gas from small producers.2/

2/ This statement of the question is essentially the question presented in the petition in No. 72-1490, and is a narrowing of, but covered by, the question presented in the petition in No. 72-1491.

STATUTES INVOLVED

Sections 4, 5, 7 and 16 of the Natural Gas Act, 15 U.S.C. 717c, 717d, 717f, and 717o, are set forth at Pet. App. G, pp. 85a-93a.

STATEMENT

This case arises from orders issued by the Federal Power Commission in a rule-making proceeding relieving "small producers" -- producers with jurisdictional sales of less than ten million Mcf of gas per year -- from certain regulatory burdens, and regulating the interstate wholesale sales of gas by small producers indirectly. The court below held that the Commission's orders exceeded its authority under the Natural Gas Act and set them aside.

1. In 1954, this Court held in Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, that the Commission has jurisdiction under the Natural Gas Act (15 U.S.C. 717, et seq.) to regulate well-head sales by producers of natural gas to interstate pipelines. Producers thus became subject to the requirements of the Act, including the certification procedures under Section 7(c)(15 U.S.C. 717f(c)), the contract filing procedures under Section 4(d) (15 U.S.C. 717c(d)), and the requirement under Section 4(a) (15 U.S.C. 717c(a)) that all rates and charges be "just and reasonable."

Following the Phillips decision, the Commission at first attempted to regulate producer sales on a traditional, individual basis. This method of regulation proved

thoroughly impractical, and in 1960 the Commission instituted area rate proceedings to determine maximum producer rates for each of the major producing areas. See Permian Basis Area Rate Cases, 390 U.S. 747, 755-758 (1968). Although the Commission now has determined an area rate for each major producing area, the area rate proceedings have proved to be enormously complex. In order to reduce the complexity, the Commission has relied on its authority under Section 16, 15 U.S.C. 717o, to "classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters."

This Court has encouraged the Commission to use this statutory authority to exempt small producers from certain provisions of the Act, first by Mr. Justice Clark in dissent (Wisconsin v. Federal Power Commission, 373 U.S. 294, 329-330 (1963)) and later reiterated by him speaking for the Court (Federal Power Commission v. Hunt, 376 U.S. 515, 527 (1964)). The Commission followed these suggestions in its first area rate proceeding and exempted small producers from various filing requirements under Sections 4 and 7 of the Act. 34 FPC 234, 235. On review, this Court sustained the Commission's separate treatment of small producers; it held (Permian Basin Area Rate Cases, supra, 390 U.S. at 787):

> We conclude that these arrangements did not exceed the Commission's statutory authority. We recognize that the language of §§5 and 7 is without exception or qualification, but it must also be noted that the Commission is empowered, for purposes of its rules and regulations, to

> "classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters." §16, 15 U.S.C. §717o. The problems and public functions of the small producers differ sufficiently to permit their separate classification, and the exemptions created by the Commission for them are fully consistent with the terms and purposes of its statutory responsibilities. It is not without relevance that this Court has previously expressed the belief that similar arrangements would ameliorate the Commission's administrative difficulties. See F.P.C. v. Hunt, 376 U.S. 515, 527. [Emphasis supplied.]

Recently the Commission, in addition to trying to deal with the problem of how effectively to regulate the thousands of natural gas producers, also has had to take into account the increasingly critical shortage of natural gas supplies. This shortage, which has been judicially recognized by this Court and the courts of appeals,[3] has seriously affected the ability of the Nation's major

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3/ See, e.g., Federal Power Commission v. Louisiana Power & Light Co., 406 U.S. 621, 626 (1972); Placid Oil Co. v. Federal Power Commission, 483 F.2d 880 (5th Cir. 1973); Public Service Commission for the State of New York v. Federal Power Commission, 467 F.2d 361 (D.C. Cir. 1972).

pipelines to meet the demands of their interstate markets. As a consequence, numerous curtailment proceedings -- of the type before this Court in Federal Power Commission v. Louisiana Power & Light Co., 406 U.S. 621 (1972) -- have been initiated before the Commission. It is in this context -- of immense complexities in regulating producer prices and of sharply rising gas shortages -- that the Commission's special treatment of small producers in this case should be reviewed.

2. In July 1970, the Commission initiated the proceedings involved here by issuing a notice of proposed rule-making proposing a regulation under which "small producers will be exempted from all provisions of the Natural Gas Act and the Commission's regulations otherwise applicable to the jurisdictional sales covered by such exemptions, except for the requirement that they submit annually a document setting forth their total volume of jurisdictional sales." 35 Fed. Reg. 12220. Although the proposed regulation was to apply to, and thus exempt from direct regulation, sales by small producers to large producers, the notice indicated that "resale of such gas by the large producer[s] would remain subject to [the] jurisdiction" of the Commission (ibid.), and that pipelines would be allowed to "track," or pass through, any price increases that resulted from the proposed regulation only if certain requirements were met. Seventy-three producers, pipelines, distributors and state commissions filed written comments (App. 135). After a conference between the interested parties and the Commission staff (App. 97-134), the Commission issued the orders in issue

here.[4/]

The Commission emphasized that "[o]ne of the important Commission responsibilities under the Natural Gas Act is to assure maintenance of an adequate gas supply for the interstate market," and that in promulgating its rule it was "taking an important step to meet this responsibility" (Pet. App. D, p. 31a). Central to its decision was the growing national crisis resulting from a shortage of natural gas. While the demand for natural gas is increasing, the supply of newly discovered gas continues to drop. Net production reached an all time high in 1970, when 21.8 trillion cubic feet of gas were produced, but even then the supply of newly discovered gas, excluding the Alaskan discoveries, was dropping. The ratio of production to reserves had declined to 13.1 by 1969, to 11.91 by 1970 and to 10.5 by 1971. The more indicative findings-to-production ratio likewise was dropping and fell below 1.0 for the first time in 1968, and since then we have continued to use more gas than we have found. 1971 Annual Report of Federal Power Commission, at pp. 31-35; see City of Chicago v. Federal Power Commission, 458 F.2d 731, 746 n. 69 (D.C. Cir. 1971), certiorari denied, 405

4/ On September 30, 1971 an adjudicatory hearing was held and on October 12, 1971 the small producers who had applied were issued blanket certificates. Less Hutt, d/b/a H & J Drilling Co., ___ F.P.C. ___ [No. CS 71-247]. The Commission has, however, continued the rule-making process involved here, and issued orders on April 10, 1972 (37 Fed. Reg. 9063) and May 4, 1972 (37 Fed. Reg. 9959) modifying the orders under review in this case.

U.S. 1074 (1972); Southern Louisiana Area Rate Cases, 428 F.2d 407, 437-455 (5th Cir. 1970), certiorari denied sub. nom. Municipal Distributor Group v. Federal Power Commission, 400 U.S. 950 (1970) (hereinafter referred to as Austral Oil Co.); Placid Oil Co. v. Federal Power Commission, 483 F.2d 880, 894-896 (5th Cir. 1973). There is, however, a tremendous volume of natural gas to be found. The best estimates are that 1,178 trillion cubic feet of probable, possible and speculative gas reserves are present in the United States. 1971 Annual Report of Federal Power Commission, at p. 34. But exploratory efforts to find this gas have dropped and continue to drop drastically; the number of exploratory wells resulting in natural gas discoveries decreased from 578 in 1966 to 481 in 1970. Ibid.

The small producers who are subject to the Commission's action here, have traditionally been and continue to be the most aggressive segment of the natural gas industry in exploring for more gas. See Permian Basin Area Rate Cases, supra, 390 U.S. at 785. Although they produce only 10.52 percent of the gas sold to interstate pipelines (Pet. App. D, p. 32a), they drill the great majority of all the exploratory wells drilled in the United States. 5/ As the Commission

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5/ Historically the small producers, who numbered 3,648 according to a recent Commission publication (Federal Power Commission, Sales by Producers of Natural Gas to Intestate Pipeline Companies 1969, p. XXI Table H), have been the most important source of exploratory drilling. For the

explained, its action in establishing the procedure for small producers involved here was intended to help alleviate the gas shortage (Pet. App. D, pp. 31a-32a):

> Such action should encourage small producers to increase their exploratory efforts which are so important to the discovery of new sources of gas. Our purpose in taking action here is not to increase contract prices, but to

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calendar year 1970, smaller independents accounted for 57.6 percent of the exploratory successes -- both oil and gas. The Oil & Gas Journal, May 29, 1972, p. 10. The same group was responsible for 81.4 percent of the new gas field discoveries in 1971 (ibid.), and for 78 percent of the new gas field discoveries in 1972 (The Oil & Gas Journal, July 2, 1973, p. 11). Other sources indicate that in 1972 independents drilled 88.92 percent of the total exploratory wells (oil and gas), and 88.60 percent of the successful exploratory gas wells. Presentation by Petroleum Information Corporation to Honorable John A. Love, Director, Office of Energy Policy, August 30, 1973. This data includes the activity of independents who, although not major integrated petroleum producers, are not small producers within the definition of Order No. 428. It does indicate, however, the significant disparity between the drilling activities of the independents and of the larger integrated enterprises, such as the Chase Manhattan Bank's group of thirty major companies. Sparling, Anderson and Dobias, Annual Financial Analyses of a Group of Petroleum Companies (1972) (Chase Manhattan Bank Study).

> facilitate the entry of the small producer into the interstate market and to stimulate competition among producers to sell gas in interstate commerce. We seek to assure the small producer that when he enters into a new contract for the interstate sale of gas, the provisions of his contract will not be subject to change. We also want to relieve the small producer of the expenses and burdens relating to regulatory matters. Our action should also ease the administrative burdens connected with processing small producer filings.

The action taken by the Commission was to establish a system under which small producers will be automatically given a certificate of public convenience and necessity at the price fixed in their contracts, and hence will be allowed to collect that price without regard to the applicable area rates fixed by the Commission. While small producers thus have greater freedom, the Commission imposed limitations on the pipelines and larger producers who buy the small producers' gas. Their right to pass on the increase to their customers is restricted. First, the contract between the purchaser from the small producer and the purchaser's customers must permit passing on the increase. Second, the increase can be passed on only if it raises the purchaser's average cost of natural gas more than one mill per Mcf. Third, the purchaser must show that the price which it pays the small producer is consistent with present or future public convenience and necessity and also is reasonable. Some of the criteria for determining whether the price is reasonable are the "highest contract prices for sale

by large producers" and "the prevailing market price for intrastate sales in the same producing area" (Pet. App. D, p. 37a; see, also, id. at pp. 34a-35a). Thus any increase that a purchaser passes on to its customers will be subject to refund if found to be unreasonable (Pet. App. D, pp. 37a-38a).

Although under Order No. 428 small producers are not required to file for rate increases, pipelines and large producers are required to file annual reports (Pet. App. D, pp. 38a-39a). Certain small producer contract provisions that lead to rate increases -- favored nation, price redetermination and spiral escalation provisions -- are restricted so that the resulting rate will not exceed the applicable area rate (id. at pp. 32a-33a). And the Commission ruled that sales made by small producers can not be abandoned even if the contract expires, without Commission authorization pursuant to Section 7 (b) of the Act (id. at p. 39a); Pet. App. F, pp. 54a-55a).

The Commission expressly stated that its action was not "deregulation" of small producer sales (Pet. App. D, p. 32a). Such sales will be regulated indirectly through review of purchased gas costs in pipeline rate proceedings (ibid.) and through the other restrictions set forth above. Large producer and pipe line rates will be subject to reduction and refund to the extent that they are based upon small producer rates which are found to be unreasonably high. The Commission concluded that this reduction and refund obligation of large producers and pipelines should provide the necessary protection of consumer interests. In order to assure the certainty of the capital flow necessary to encourage exploration and development by

small producers, the Commission exempted small producers from any refund obligations (id. at pp. 37a-38a).

Finally, the Commission expressed its intention (Pet. App. D, p. 40a)

> * * * to review the prices established in new contracts or contract amendments relating to sales by small producers to assure the reasonableness of the rates charged by such producers pursuant to the action we are taking herein. In the event we determine that this approach is inimical to the interests of consumers, we shall take further action to protect the consumers.

In April 1971, the Commission issued Order No. 428-A (Pet. App. E, pp. 47a-49a) prescribing the form of the annual statement to be filed by small producers operating pursuant to the blanket certificate procedure thus established. In July 1971, the Commission issued Order No. 428-B (Pet. App. F, pp. 50a-84a) modifying Order No. 428 in certain respects and denying applications for rehearing.

3. On petitions for review,[6/] the court of appeals, with one judge dissenting, set aside the Commission's orders establishing the blanket certificate procedure for small producers (Pet. App. A, pp. 1a-22a). The Court concluded that, by authorizing blanket

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6/ Petitioners in No. 72-1491 intervened in the court of appeals in support of the Commission.

certificates for small producer sales, the Commission had abdicated its statutory responsibilities under Sections 4 and 5 of the Act to insure that small producer rates will be "just and reasonable" (id. at pp. 10a-16a). The court rejected the Commission's contention that its action was a permissible classification under Section 16 of the Act on the gound that that section "does not give the Commission independent powers," but rather only power to implement "the core sections of the Act, such as Section 4" (id. at p. 10a). Nor, the court held, could small producer sales appropriately be regulated indirectly through the controls imposed by the Commission, since these were based on "factors which it does not regulate or which derive solely from market forces" (id. at p. 12a).

Judge Fahy dissented. In his view the only question before the court was "whether we can hold, on the record before us, that the type of regulation of prices adopted by the Commission has led or will lead inevitably to unjust or unreasonable rates charged by small producers to purchasers of gas from them * * *" (Pet. App. A, p. 19a). Citing this Court's recent decision in Federal Power Commission v. Louisiana Power & Light Co., 406 U.S. 621 (1972), he concluded (id. at pp. 19a-20a):

> The Commission has made a judgment which I think is within the ambit of its competence and expertise not to require small producers to be bound to the area rate and certain filing requirements, on an experimental basis. * * * The Commission is attempting to learn whether under this program the small producers, relieved of much

> of the burden of regulation required of other classifications, can improve their exploratory efforts while charging rates which on review will nevertheless prove to be just and reasonable, and which will not adversely affect the consumer interests protected by the Act. [Footnotes omitted.]

SUMMARY OF ARGUMENT

Order No. 428 is a reasonable experiment by the Federal Power Commission to elicit critically needed natural gas. The Commission carefully weighed the interest of the consumer and temporarily determined that the necessary supply at the lowest price to him would be forthcoming if the small producer were permitted to receive the contract price, the variable field price, for natural gas.

Section 4(a) of the Natural Gas Act requires that all rates for the sale of natural gas be "just and reasonable". Nowhere does the Act expressly require a particular rate or preclude the Commission's reliance upon market mechanisms in determining what complies with the statutory standard. Indeed, consistent with this standard the Court has inculcated in the authority of the Commission the flexibility vital to its ability to resolve the complex problems of administrative delay and gas supply. In the evolution of the statutory standard this Court has suggested that the Commission could determine that market mechanisms would result in just and reasonable rates. Permian Basin Area Rate Cases, 390 U.S. 747 (1968).

In this case the Commission followed this suggestion but carefully structured the market environment. It correctly reasoned that both the small producer's historical market position and the constraints that Order No. 428 imposed upon him and upon the pipelines and large producers who buy his gas provide sufficient protection to the consumer against unreasonably high prices. Predicated upon the small producer's small volume of sales but traditionally extensive exploratory efforts, the Commission reasonably concluded that the consumers would receive the maximum exploratory return for the minimum cost.

Although the prices received by small producers for their gas continue to be subject to review, the Commission concluded that they would not have any obligation to refund amounts previously collected if the Commission later determined that rates were too high. The Commission has broad discretion as to whether refunds under Section 4(e) are to be ordered, and it did not abuse its discretion in freeing the small producer from future refund obligations. The Commission correctly concluded that the threat of refund was detrimental to the degree of exploration it sought to elicit, and, on the balance, that the market mechanism defined under Order No. 428 would produce a just and reasonable rate.

ARGUMENT

THE NATURAL GAS ACT AUTHORIZES THE FEDERAL POWER COMMISSION TO REGULATE INTERSTATE GAS SALES OF SMALL PRODUCERS INDIRECTLY THROUGH REVIEW OF THE COSTS OF SUCH GAS TO PIPELINES AND LARGE PRODUCERS AND THROUGH MARKET FORCES.

The important question in this case is whether the Commission exceeded its authority under the Act in relying on indirect regulation and market forces to produce a just and reasonable rate for natural gas sales by small producers. The court below held that basing rates on market factors is the "antithesis of regulation" (Pet. App. A, p. 11a n. 18) and thus is not permissible under the Act. In doing so the court deprived the Commission of authority to make pragmatic adjustments in its regulatory procedures in order, consistently with its regulatory obligations, to help alleviate the critical shortage of natural gas which now concerns the Nation.

A. The requirement of Section 4(a) of the Natural Gas Act that all rates for the sale of natural gas be "just and reasonable" does not require the Commission to set a particular maximum rate or preclude reliance on market mechanisms as a means of achieving just and reasonable rates.

Since its initial construction of the Natural Gas Act this Court has recognized that although Congress provided no definition of the standard "just and reasonable," it was intended to imbue the Act with the flexibility vital to its effective administration. The Court indicated that no single legalistic formula could provide a solution

to the myriad of problems which would inevitably confront the Commission. Instead the Court emphasized the Commission's broad responsibility in rate-making to balance the consumer's right to receive gas at a reasonable rate to him with the investor's interest in maintaining the fiscal integrity of his venture. Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 586 (1942). The focal point of the "just and reasonable" concept was in preserving this balance. Since during those early years of administration under the Act there was a seemingly endless supply of natural gas, maintaining an adequate supply of gas was not an important element in the equation.

In Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1943) the Court further vitalized the concept of "just and reasonable" rates. The Court refused to permit the ossification of the administrative process, which it recognized would be the inevitable result should the validity of the Commission's determination of just and reasonable be contingent upon the empirical precision of its analysis. Conscious of the difficulties inherent in balancing the consumer and investor interests, the Court adopted the total effect standard for judicial review of a rate order (320 U.S. at 602):

> * * * Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling. * * * It is not theory but the impact of the rate order which counts. If the total effect of the rate cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed

> to reach that result may contain infirmities is not then important. Moreover, the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.

On balance, the Court held that the Commission's use of a rate base to fix rates for Hope was not unreasonable. Hope, as have Respondents in this case, failed to demonstrate that the expert judgment of the Commission was unjust or unreasonable in its consequences. This case also brought forth additional considerations. The advent of the gas shortage in the Applachian Field where Hope produced and acquired its gas precipitated the injection of supply-incentive factors into the balance. The Court noted that if the rates were inadequate for development of new sources of supply, the Commission was authorized to make allowances therefor. 320 U.S. at 615. The injunction to the Commission was to fulfill the needs of the consumer at the minimum cost that would elicit an adequate supply.

The Court's decision in Hope was whether a particular rate -- a certain number of cents per Mcf -- was "just and reasonable" in the light of the expenses of the natural gas company -- its rate-base. But in Colorado Interstate Gas Co. v. Federal

Power Commission, 324 U.S. 581 (1941), the Court indicated that the Commission had the authority, although not the duty, to depart from the rate-base method of determining a just and reasonable rate. 324 U.S. at 601. The clear implication was that the Commission could and should do so in appropriate circumstances.

In the area rate proceedings the Commission looked to average expenses of all the companies to determine whether a rate was "just and reasonable" instead of the rate-base of a particular company. See Permian Basin Area Rate Cases, 390 U.S. 747 (1968). In addition, the Commission in these proceedings added non-cost factors to the balance. E. g., id. at 815. But until it issued Order No. 428 the Commission always had approved a particular rate ceiling as the "just and reasonable" rate. When the Commission had previously been invited by large producers and pipelines to approve a variable field price as either cost, expense or the producer rate itself, it justifiably refused to do so because of the impact on the consumer. This Court in Permian affirmed this refusal. 390 U.S. at 795.

However, the Commission's previous rejection of the concept of a fluctuating "just and reasonable" rate and the Court's approval of the rejection of such a concept in no way indicated that such a concept was forbidden by the simple phrase "just and reasonable", which is the only standard set forth in the Act. On the contrary, as early as Colorado Interstate Gas Co., v. Federal Power Commission, supra, 324 U.S. at 600-601, the Court indicated that had the Commission opted to permit the pipeline to include in operating expenses its gas production at the variable market price the Commission's

decision would not have been disturbed. And in Permian the Court, in again approving the Commission's rejection of variable or market based just and reasonable rates, admonished as follows (390 U.S. at 795):

> "We do not now hold, and the Commission has not suggested, that field prices are without relevance to the Commission's calculation of just and reasonable rates under §5 (a). The records in subsequent area proceedings may more clearly establish that the market mechanism will adequately protect consumer interests. We hold only that, on this record, the Commission was not compelled to adopt field prices as the basis of its computations of area rates." (Emphasis added.)

The Court has not intimated that the finding of a specific rate or even a certain price ceiling is the essence of the requirement that a rate be "just and reasonable." Such a rule would excise much of the Act's flexibility that the Court has so painstakingly developed. Instead, the essence is the attempt to provide the balance between the investor and the consumer interests, referred to in Natural Gas Pipeline Co. and in Hope. And if Order No. 428 reflects such a balancing of interests by the Commission and that balancing is not unreasonable or unjust, the Order must be sustained.

B. <u>Order No. 428 is reasonably designed to result in a just and reasonable rate for gas sold by small producers</u>.

Order No. 428 does not represent the simplistic idea that the market will in all events produce a just and reasonable rate for all natural gas. Rather it represents the Commission's decision that market prices in a particular, carefully-circumscribed market for a small portion of the industry[7/] can reasonably be expected to produce such a rate.

The rates that small producers will receive under Order No. 428 will vary in response to market factors in the particular market for their natural gas. The Commission promulgated its order in light of these factors and attempted to devise restrictions that

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7/ We believe there can be no question that the Commission acted properly in classifying the small producers for the experiment provided under Order No. 428. Section 16 of the Act (15 U.S.C. 717o) empowers the Commission, for purposes of its rules and regulations, to "classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters." This Court in <u>Permian</u> relied squarely on Section 16 in sustaining the Commission's special treatment of small producers (390 U.S. at 787). See also, <u>Federal Power Commission</u> v. <u>Louisiana Power & Light Co.</u>, <u>supra</u>, where the Court emphasized that Section 16 assures the Commission in administering the Act "the necessary flexibility" to make the pragmatic adjustments required by particular circumstances (406 U.S. at 642).

would tend to provide consumers added protection against unreasonably high prices. First, the vast majority of the natural gas that reaches the interstate market is sold pursuant to contracts negotiated many years ago in the era when rates for natural gas were low.8/ Those contracts are generally long-term, often for the life of the field where the gas is produced, and under Order No. 428 those contracts are going to continue in effect; Order No. 428 itself precludes any abandonment of sales of gas heretofore or hereafter dedicated to interstate commerce. Thus although a small producer's contract may expire, he is obligated to continue selling the jurisdictional gas to the purchaser under the old contract, and at the area rate unless that purchaser agrees to pay a greater price, which he has no reason to do. See Pet. App. D, p. 36a n.4.9/

Second, the Commission proscribed certain market practices that might lead to unreasonably high prices. Favored nation, price redetermination and spiral escalation clauses in small producer contracts are not effective to the extent they result in prices above the applicable area rate.

8/ As of January 1, 1974, 62 percent of all jurisdictional gas will be sold pursuant to contracts with fixed prices below area rate ceilings. Foster Associates, Inc., The Impact of Deregulation on Natural Gas Prices, p. 4 (August 1973).

9/ The small producer is barred from making any unilateral rate increases. See, e.g., United Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332 (1956).

Third, market constraints on the small producers' rate bargaining ability exist and were considered by the Commission as viable and productive of a cost to the consumer commensurate with the exploratory benefits likely to result. The small producers are just that -- small. Although they account for the bulk of all explorations for new natural gas supplies, their gas sales constitute a relatively small percentage of the total sales in interstate commerce.10/ Large producers and pipelines account for the balance of such sales. And the more than 3600 small producers generally have to sell their gas to a large producer or a pipeline, whose bargaining power is dominant compared with that of the small producer.11/ The individual small

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10/ The sales for 1970 and 1971 were respectively 11.2 and 11.1 percent of the total volume. Federal Power Commission, Sales by Producers of Natural Gas to Interstate Pipeline Companies 1970, p. XXI Table H; Federal Power Commission, Sales By Producers of Natural Gas to Interstate Pipeline Companies 1971, p. XXII Table H. These figures are in line with the Commission's estimate of 10.52 percent based on its 96-company sample (Pet. App. D, p. 32a).

11/ See Douglas, "The Case for the Consumer of Natural Gas," 44 Geo. L. J. 566, 579-580 (1956); Diener, "Area Price Regulation in the Natural Gas Industry of Southern Louisiana," 46 Tul. L. Rev. 695, 721 (1972). Indeed, large producer market concentration is extreme; four companies hold approximately 50 to 75 percent of all available reserves. Statement of Lee C. White, Chairman of the Energy Policy Task Force, Consumer Federation of America, before the Senate Commerce Committee, October 25, 1973, at p. 7.

producer who discovers gas is not in a position to withhold it from the market, and to pay the completion expenses and shut-in royalty that would result, until he can get a higher price. Moreover, the bargaining disadvantage the small producer faces is increased by the limits on the types of operations he can conduct.

The small producer basically has two options. He can farm-out -- sublease as lessee -- a small portion of acreage from a large tract that a large producer has under lease. Typically the large tract will be mostly unexplored, however, and the small producer will be allowed to share only in the production that he discovers and, if he is successful, to develop some acreage adjacent to the discovery well, perhaps enough for several more wells. The large producer will then proceed to develop the rest of the field. In such a situation the small producer must sell at the same price as the large producer who owns the field; there is no reason for a purchaser to pay a higher price to the small producer since his gas can simply be drained away by the large producer who is producing gas all around him.

The small producer's second option is to engage in wildcat operations in areas that are mostly unleased and concerning which there is little geophysical and exploratory data. These unleased areas are usually far removed from any existing pipeline. By drilling such wildcat wells he is performing the exploratory function for which he has become the recognized leader in the industry. But if he finds gas, there is no market for that gas until enough successful wells are drilled to establish that there is enough gas to attract a pipeline into the area. He has no revenue until he obtains a pipeline

connection. And when this occurs he either must agree to sell to the pipeline at a price largely determined by it, or again be faced with paying shut-in royalties and other expenses without any income. Thus both methods in which the small producer conducts his drilling operations -- the farm-out and the wildcat -- place him at a serious competitive disadvantage.

Finally, the Commission did not rely solely on existing market forces to protect customers against paying unreasonably high prices to the small producer. Order No. 428 added to the existing market conditions additional protection by encouraging the customers of small producers to bargain hard in connection with the purchase of newly discovered gas. It imposed restrictions on the ability of the large producers and pipelines to pass through to their consumers rate increases paid to the small producers. They cannot pass through any increase until the total increases raise the average cost of gas of the particular pipeline or large producer at least one mill per Mcf. And they will not be allowed to pass through increases if the rate paid to the small producer is unreasonably high.

2. Order No. 428 thus reflects an effort by the Commission to establish a system of variable prices based on a very special, limited circumstance. In this context, we submit, the Commission can reasonably anticipate that the prices received by small producers will be "just and reasonable". While there is nothing inherent in Order No. 428 that will require the prices that small producers receive to rise, it is obvious that in view of the present critical shortages the prices small producers will receive under this system will be higher than the prices that were being received before the order was issued. The

Commission was aware that the prices likely would increase, but it was trying to create a system where the increased price would result in a reasonable rate and at the same time provide a meaningful incentive to increase exploration activity and the supply of natural gas.12/ In doing so the Commission sought to use price functionally as a tool to elicit additional supply, as it clearly is entitled and indeed obligated to do. See, e.g., Permian Basin Area Rate Cases, supra, 390 U.S. at 798-801. Moreover, the Order will enable prices to be set and adjusted without the necessary administrative delays inherent in the rate-base and fixed-price regulation system.

Prices for small producer gas thus will be allowed to fluctuate with the supply of gas, in the open market but subject to the controls established by the Commission. Mr. Justice Jackson, concurring in Colorado Interstate, advocated just this sort of

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12/ The Commission's recent efforts to increase the supply of natural gas by providing higher gas prices, through increased rates for the small producers under Order No. 428 and for interstate gas generally, in combination with higher prices for intrastate gas, have markedly affected the exploratory drilling effort. Exploratory drilling increased 16 percent for the first six months of 1972, and is estimated to have increased 32 percent for the entire year. See XLIII Petroleum Independent, Sept.-Oct. 1972, at p. 5; The Oil & Gas Journal, July 2, 1973, at p. 10. Apparently the same trends have occurred in 1973. See The Oil & Gas Journal, November 5, 1973, at p. 105.

regulation (324 U.S. at 612):

> Far-sighted gas-rate regulation will concern itself with the present and future, rather than with the past, as the rate-based formula does. It will take account of the conditions and trends at the source of supply being regulated. It will use price as a tool to bring goods to market -- to obtain for the public service the needed amount of gas. * * * The problem, of course, is to know what price level will be adequate to perform this economic function.

The Commission has tried this on an experimental basis using the indirect system of regulation under Order No. 428 for only the small producer segment of the industry, in an effort to achieve the ideal price to which Justice Jackson referred

While the Commission delineated neither the effect that Order No. 428 would have on the exploratory activities of the small producer nor the effect it would have on the gas price to the ultimate consumer, sufficient public data exist from which plausibly to estimate these effects.13/ Of course, "the impact of an

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13/ The data are set forth in Foster Associates, Inc., The Impact of Deregulation on Natural Gas Prices (August 1973), and in Federal Power Commission, Sales by Producers of Natural Gas to Interstate Pipeline Companies 1971, Tables A and H. The calculation is as follows: The average revenue per Mcf for all natural gas sold to interstate pipelines in 1971 was 19.65 cents. The price of 62 percent of such gas is fixed below area rate ceilings (note 8, supra, p. 22), so only 38 percent of such gas is subject to any

increased rate upon the consumer results only from the average price paid by the pipeline for all of its gas, and the amounts of gas sold by small producers do not substantially affect the results as a whole." Permian Basin Area Rate Proceedings, 34 FPC 159, 361 (1965). As concerns gas already dedicated to the interstate market under existing contracts, if it is assumed that a maximum increase will occur the funds thus generated would enable the small producers to drill 3,000 additional exploratory wells 7,000 feet deep each year. The maximum increase to provide these funds would increase the residential consumer's annual bill only 6 percent. These estimates further support the Commission's regulatory scheme under Order No. 428, and the experiment should be given an opportunity to work.

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increase. The small producers accounted for approximately 11.1 percent of sales by all producers; multiplying this by the total natural gas subject to a price increase, the maximum amount of natural gas subject to possible price increase to the small producers by reason of Order No. 428 would be 615,736,0[illegible] Mcf. Assuming that the average gas price received by the small producer under Order No. 428 will increase fourfold -- from 19.65 cents to 78.6 cents -- and that this increase will be absorbed solely by residential consumers, who total approximately 39,416,000, their average annual gas bill, now at $155, would increase by $9.20, or 6 percent. As we point out in our argument, the likely price increase will be much less than fourfold because the market as it exists and as structured under Order No. 428 will not permit it. Moreover, while we have assumed here that the entire burden of the increase would fall on the residential consumer, in actuality any increase resulting under Order No. 428 will be

3. The court of appeals was particularly troubled by the two factors mentioned by the Commission as relevant to determine whether prices paid small producers by large producers and pipelines are unreasonable. It stated that it was improper to look to the highest contract prices for sales by large producers or the prevailing market price for intrastate sales in the area, since the Commission did not directly control these factors. But this is only part of the scheme used in Order No. 428. And the issue in this case is not whether any one element in the overal scheme is beyond the Commission's control or whether the rates received by the small producers' customers are just and reasonable. The issue is whether the Commission acted unreasonably

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borne by the industrial user as well.

The beneficial impact of Order No. 428 on the small producers' ability to conduct exploratory efforts will be significant. The per foot dry hole costs (the cost simply to determine if any gas exists) is approximately $16.02. <u>The Oil Producing Industry in Your State</u>, at p. 99 (1973). Based on the assumed price increase stated above and the increased revenues to small producers that this would generate, small producers would have additional funds available to drill approximately 22 million feet of gas well tests. This amount of additional exploratory effort would provide approximately 13 percent of the total 1973 exploratory activity recommended by the Commission's staff to achieve a proper level of supply. See Federal Power Commission, <u>Staff Report on National Gas Supply and Demand</u>, at p. 34 (1969).

in concluding that the entire system of small producer pricing established in Order No. 428 will produce just and reasonable rates for small producers, with an appropria balancing of the interest of the public to have an adequate supply of gas, the interest of the consumer to buy gas at the lowest rea sonable rate and the interest of the investo to have a fair return on investment. Federa Power Commission v. Hope Natural Gas Co., supra, 320 U.S. at 602-603.

Moreover, even these announced criteria are within the Commission's authority. This Court has approved the Commission's consideration of negotiated prices as an important element in arriving at an area rate. Permia Basin Area Rate Cases, supra, 390 U.S. at 795 n. 67. The Commission stated here that in reviewing the pipeline rates, it would consider all relevant factors, not just the intrastate market price and the large producer contract prices. And it is obvious that where there is competition between inte state and intrastate markets, the Commissio must be allowed to consider intrastate price so that the interstate market can compete for the gas.14/ Placid Oil Co. v. Federal

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14/ Nor is there any reason to assume that the consideration of intrastate rates will inevitably result in excessive rates. In Other Southwest Area Rate Cases, 5th Cir., No. 72-1114, decided June 8, 1973, slip op. at p. 19, the court noted "A careful examina tion of intrastate rates shows that the 'new gas rates established [by the Commission] * * * exceed the weighted average of current intrastate sales in every sub-area except Other Oklahoma."

Power Commission, supra, 483 F.2d at 905; In re Hugoton - Anadarko Area Rate Case, 466 F.2d 974, 989 (9th Cir. 1972). Finally, comparison of small producers rates to those of intrastate sales and highest large producer contracts is little more than consideration of a non-cost factor, like those which the Commission has included, and this Court has approved, in determining just and reasonable rates. Permian Basin Area Rate Cases, supra, 390 U.S. at 815; see also, Austral Oil Co., supra, 428 F.2d at 425-427.

C. The Commission acted properly in stating that small producers will have no refund obligation for rates collected pursuant to Order No. 428.

The court of appeals expressed concern that under Order No. 428 the Commission had abandoned any future review of small producers rates (Pet. App.A, p. 12a n. 21). Although the order specifically provides that the Commission is going "to review the prices established in new contracts or contract amendments relating to sales by small producers to assure the reasonableness of the rates charged" and will take further action if it finds "that this approach is inimical to the interests of consumers" (Pet. App. D, p. 40a), the Commission did indicate that if future review showed that small producer rates are too high it would not order refunds of the amounts collected earlier in excess of what it found to be the just and reasonable rate (id. at 37a). The small producer, who generally is not debt financed and must rely on flowing gas sales to generate necessary capital for exploration, should not be subject to refund because otherwise he would necessarily withold some revenue from his drilling activity in order to insure that he can meet any future refund requirements

(App. 84).[15/] Exempting the small producer from the refund requirement in the circumstances here is well within the scope of the Commission's authority under section 4(e) of the Act.

Section 4(e) provides that "the Commission may require the natural gas company * * * to refund any amounts ordered by the Commission," and is empowered "to order such natural gas company to refund, with interest, the portion of such increased rates" which it concludes is not justified. In Placid Oil Co. v. Federal Power Commission, supra, the Fifth Circuit affirmed the Commission's reduction in refund obligations for the Southern Louisiana Area from $375 million to $150 million. The court also approved a procedure that allowed those producers owing refunds to cancel their refund obligation by committing new gas to interstate commerce. It held that the refund provision of Section 4(e) was permissive, not mandatory, and afforded the Commission the necessary latitude to achieve the overriding public interest -- an adequate supply of gas at a reasonable price. Chief Judge Brown explained the Court's reasoning as follows (483 F.2d

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15/ The amount of revenue withheld from drilling activity will, of course, increase when the potential refund obligations of the small producers increase and when there is great uncertainty about whether those obligations may be increased. This uncertainty is particularly great where the Commission's area rate, the only approved rate, has been overturned, as is the situation in the Texas Gulf Coast Area. See Texas Gulf Coast Area Rate Cases, D. C. Cir., No. 71-1828, decided Aug. 24, 1973.

at 905):

> * * * Federal Power Commission does not <u>have</u> to order refunds under the terms of the Natural Gas Act. It <u>may</u> do so. And to the extent that it does order refunds, it is empowered to adopt a schedule or structure of refunds which it, in its administrative discretion and expertise, believes will fairly balance the interests of both consumers and producers while achieving the overriding public interest, that interest in the 1970's being the quest for an increased supply to meet an insatiable demand. [Footnotes omitted.]

As we view this case, however, the Commission in declaring that it would not order retroactive refunds by small producers was merely stating what the Act otherwise provides. For the prices that the small producers will receive under Order No. 428, by reason of the structure which the Commission has established, will be just and reasonable. There is no obligation to refund with respect to such rates. Refunds will become an appropriate concern only if the Commission, in its continuing review of the action taken by it here, decides that rates should be fixed some other way for subsequent production.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed and the orders of the Federal Power Commission should be sustained.

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PROOF OF SERVICE

The undersigned, a member of the Bar of this Court, hereby certifies that a copy of the foregoing Brief has this the 21st day of November, 1973 been served upon each counsel of record for respondents in accordance with Rule 33 of this Court, by depositing the same in a United States mail box, with first class postage prepaid, addressed to said counsel at their post office addresses.

Ben F. Vaughan

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